United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING

ORIGINAL

75-7503

United States Court of Appeals

FOR THE SECOND CIRCUIT

SUSAN TANNENBAUM,

Plaintiff-Appellant,

—against—

ROBERT G. ZELLER, F. EBERSTADT & CO., INC., F. EBERSTADT & CO., MANAGERS AND DISTRIBUTORS, INC., and CHEMICAL FUND, INC.,

Defendants-Appellees.

BRIEF OF INVESTMENT COMPANY INSTITUTE, *AMICUS CURIAE* IN SUPPORT OF REHEARING

FRIED, FRANK, HARRIS, SHRIVER & JACOBSON
Attorneys for Investment Company Institute
120 Broadway
New York, New York 10005
(212) 964-6500

DAVID SILVER, ESQ.
Senior Vice-President
and General Counsel
Investment Company Institute

MATTHEW P. FINK, ESQ.
Associate Counsel
Investment Company Institute
Of Counsel

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BRIEF OF INVESTMENT COMPANY INSTITUTE, *AMICUS CURIAE* IN SUPPORT OF REHEARING

This brief is submitted on behalf of the Investment Company Institute ("I.C.I.")[1] as *amicus curiae* in support of the petition of Defendants-Appellees Robert G. Zeller, F. Eberstadt & Co., Inc. and F. Eberstadt & Co., Managers and Distributors, Inc. requesting a rehearing by the original panel (Lumbard and Timbers, *Circuit Judges,* and Bryan, *District Judge*) of the decision it rendered March 4, 1977 or, alternatively, suggesting that the Court review that decision *en banc.* This brief is submitted conditionally pursuant to Rule 29 of the Federal Rules of Appellate Procedure in the event that the accompanying motion of the I.C.I. for leave to file the brief is granted.

The I.C.I. urges a rehearing in respect of the Court's determination that the proxy statements of Chemical Fund,

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[1] The I.C.I. is the national trade association of open-end investment companies ("mutual funds"), their advisers and underwriters. The mutual fund members of the I.C.I. have about 8 million shareholders and assets of about $43 billion, representing over 90% of the assets of the domestic mutual fund industry.

Inc. (the "Fund"), a Delaware corporation, for the years 1967-1971 violated the disclosure provisions of the federal securities laws by failing to disclose the possibility of recapture of the "excess" portion of portfolio brokerage commissions (referred to as "recapture") and the decision of the independent directors of the Fund to forego recapture. This brief is addressed solely to this aspect of the Court's decision.

The Court's decision is of major consequence to the entire mutual fund industry.

1. Under applicable law and for pertinent policy considerations, disclosure of the possibility of recapture and a decision of the independent directors to forego recapture is not, and should not be, required—particularly in the context of a decision characterized by the Court as a reasonable business judgment (slip opinion 6319). This type of disclosure (i) has never been required by the Securities and Exchange Commission (the "SEC") and, indeed, was specifically considered and rejected by the SEC after being proposed for public comment as a possible disclosure guideline; (ii) generally is not reflected in proxy statements of mutual funds during the period in question and, thus, is contrary to long-standing industry understanding and practice; (iii) is inconsistent with the reliance placed on the independent directors by the Investment Company Act of 1940 (the "1940 Act"); and (iv) will not provide information that is relevant to shareholders of a mutual fund.

2. The Court's decision that a long-standing industry disclosure practice was, in retrospect, incorrect could have a widespread disruptive impact upon the mutual fund industry, even though the disclosure at issue relates to a practice, the possibility of recapture, which generally is now obsolete in light of the advent of competitive brokerage rates.

I.

Under applicable law and industry practice disclosure of the possibility of recapture and the decision of the independent directors to forego recapture is not, and should not be, required.

A. *The SEC has not required disclosure of the possibility of recapture and the decision not to recapture and such disclosure has not been common practice in the mutual fund industry.*

In general, the materiality of a disclosure depends on the facts and circumstances of the particular event. However, the type of disclosure about recapture which the Court has suggested may be characterized as "generic" in nature, since it was a disclosure which would be common to many mutual funds. The factual variables in this context would seem limited.

Unlike the case with industrial or other companies, mutual funds are under continuing surveillance by the SEC as a result of its constant review of filed materials (proxy statements, current prospectuses and annual reports), inspections and investigations of practices and procedures, and its substantive regulation over their activities. The SEC has also been active in the development of specific disclosures for mutual funds, and the mutual fund industry has grown to rely upon the SEC practice of establishing disclosure guidelines, including those relating to the form and content of generic disclosures.[2] Thus, mutual fund disclosures have been both standardized and increased in a standardized manner through a process of accretion, primarily in response to SEC requirements, whether by the so-called "letter of comment" technique or by the adoption by the SEC of specific disclosure guidelines.[3] This, in large part, accounts for the fact that a number of the dis-

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[2] Mutual funds continuously register their shares under the Securities Act of 1933 (the "1933 Act").

[3] *E.g.*, SEC Guidelines for Investment Company Registration Statements, Release No. 40-7220 (1972). The disclosures suggested in the guidelines, to the best of our knowledge, have been generally adopted in the mutual fund industry with only minor variations.

closures made by a particular mutual fund are routinely strikingly similar to the disclosures made by many other mutual funds.

During the period in question there was, and currently is, nothing in the SEC forms for proxy or registration statements or otherwise which expressly required, or would suggest, the need for the disclosure as to recapture which the Court would require. The SEC had considered and subsequently rejected a disclosure guideline concerning the possibility of recapture. In 1969 the SEC published for comment proposed guidelines for the preparation of Forms S-4 and S-5,[4] which would have required mutual funds to disclose the facts that recapture was possible and that the directors had elected not to recapture.[5] After comments received in response to these proposed guidelines were considered by the SEC, it formally decided in 1972 not to require this disclosure. Disclosure relating to recapture was required by the SEC only in instances where a mutual fund did recapture.[6] Thus, the SEC necessarily determined

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[4] Forms S-4 and S-5 are the applicable registration statement forms under the 1933 Act .

[5] Release No. 40-5634. Two alternative forms of suggested disclosure proposed by the SEC in this release were as follows:

Alternative #1:

"The Company's board of directors and its adviser could agree to make arrangements to return to the Company the benefit of a portion of the brokerage commissions charged on portfolio transactions. No such arrangements have been made."

Alternative #2:

"The Company's board of directors and its adviser could agree to make an arrangement with ..... & Company to return to the Company benefits equal to the brokerage commissions ..... & Company receives on portfolio transactions from which the investment adviser benefits. No such arrangement has been made."

[6] Release No. 40-7220. The form of suggested disclosure adopted by the SEC in this release was as follows:

"The Company and ..... & Company have made an arrangement whereby .....% of the net profit from brokerage commissions earned on Company transactions placed with ..... & Company is returned to the Company by ..... (describe the mechanism through which the Company benefits, e.g. in a reduction in the advisory fee)."

that disclosure about the possibility of recapture, and the directors' rejection of this option, was not material for inclusion in documents prepared in accordance with the federal securities laws.[7] In respect of the generic disclosure under analysis, a determination by the SEC as to the adequacy of the disclosure should be entitled to significant weight in light of the continuous review by the Staff of the SEC of proxy statements, prospectuses and reports of all mutual funds; the SEC's expertise and specific examination of industry-wide practices dealing with recapture and brokerage allocation; and the SEC's awareness of the industry practice of reliance on a general disclosure pattern.

To the extent we have been able to determine, it was not the practice for those mutual funds which had decided not to recapture[8] to disclose that the directors had considered and rejected recapture.[9] Thus, such a disclosure obligation, retroactively imposed, could expose a substantial part of the industry to claims of liability uncertain in nature and amount for past conduct which, at the time, was in accordance with applicable laws as then interpreted.

B. ***The interests of the shareholders of mutual funds are protected by the independent directors.***

More so than has been typically the case with industrial or other types of corporations, the 1940 Act has always contemplated an active role for the independent directors

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[7] The SEC decision on this issue should apply with equal force to the disclosure requirements for proxy statements. The Court had narrowed its holding to the proxy statements of the Fund for procedural reasons (slip opinion 6319-6320).

[8] A decision to forego recapture during this period was, in our belief, not unique in that a number of other mutual funds had made similar decisions. This was due in part to the fact that the law was unclear as to the circumstances under which recapture was permitted or required due to the inherent conflict of interest (real or apparent) in permitting recapture. The possibility of a conflict of interest was one of the factors considered by the independent directors of the Fund (slip opinion 6315-6316).

[9] This conclusion is based upon our knowledge of the mutual fund industry and a review of proxy statements of various mutual funds for the period in question.

of mutual funds as "watchdogs" for the interests of the shareholders.[10] In fact, Congress, recognizing that shareholders of mutual funds are disinclined to remove or change a mutual fund's adviser,[11] strengthened the role of the independent directors by enacting the Investment Company Amendments Act of 1970 (the "1970 Amendments"), the provisions of which were applicable for a part of the period in question. The Court's decision on recapture disclosure is inconsistent with the Congressional intent as to the purpose and the role of mutual fund independent directors.

The Court found that the independent directors of the Fund were fully and adequately informed by management of the possibility of recapture and that the directors did not breach their fiduciary duties to Fund shareholders by electing not to recapture (slip opinion 6318-6319). Therefore, in terms of the impact of the Court's decision on the mutual fund industry, the environment is one in which the independent directors have exercised a reasonable business judgment, and, in such an environment, the interests of the shareholders are adequately protected without disclosure of the alternatives considered by the independent directors.

The interests of the shareholders of the Fund were also protected by the fact that more than 50% of the directors of the Fund were independent for the entire period in question.[12] Moreover, while the concept of a "disinterested" director was not introduced until the enactment of the 1970 Amendments, the independent directors were *in fact* "disinterested" for the entire period in question (slip opinion 6279).

To require disclosure of the possibility of recapture and the independent directors' decision to forego recapture in these circumstances suggests that the action of the independent directors was suspect, and that shareholders should be fully informed respecting all possible alter-

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[10] See, *e.g.*, Sections 10(a), 15(c) and 32(a).

[11] See S.Rep. No. 91-184, 91st Cong., 2nd Sess. (1970).

[12] See Section 10 of the 1940 Act.

natives of a good faith, disinterested judgment of the independent directors on what could only be the premise that the decision may not have been made properly. A decision to forego recapture is similar to many other alternatives relating to advisory agreements which the independent directors from time to time may consider. If the possibility of recapture should be disclosed, why not disclose other alternatives which can have a direct monetary impact on mutual funds—or, perhaps, the individual votes of directors on different issues? The securities laws traditionally have not required disclosure of this type of evaluation of alternatives, certainly not in the context of deliberations by independent parties, such as the independent directors in question.[13]

C. *The omission of a disclosure in proxy materials as to the possibility of recapture and the decision of the independent directors to forego recapture is not material.*

The proxy provisions of the federal securities laws have been adopted as a means to furnish shareholders with information as to which there is a substantial likelihood that a reasonable shareholder would consider important in deciding how to vote. See *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L. Ed.2d 757 (1976). Matters as to which shareholders' votes were solicited in the instant case were the election of directors and the approval of the investment advisory agreement (slip opinion 6328), and, to be material under the standard established in *TSC Industries,* it is necessary to determine that the information in question would be important in a determination of the qualifications of the per-

[13] If the state corporation laws are viewed for guidance, there is typically a separation between the type of decisions that are made by the directors and those which require shareholder approval. A decision concerning an issue such as the possibility of recapture is usually left to the discretion of the directors, who are charged with the fiduciary duty of managing the business and affairs of the corporation. In requiring the disclosure of the decision making process of the directors such as the consideration of the possibility of recapture, the Court's decision may inhibit the free flow of ideas among the directors, thereby undercutting their effectiveness in managing the business and affairs of corporations as required by state law.

sons nominated for election as directors[14] or would be important to an evaluation of whether to approve an investment advisory agreement submitted to the shareholders.

Their good faith business judgment whether or not to attempt to recapture does not, we respectfully submit, concern the qualifications of the directors. Indeed, the Court found that the actions and decisions of the independent directors were reasonable business judgments properly considered and determined (slip opinion 6319). This holding is inconsistent with any suggestion that the qualifications of the directors were in question. Moreover, the availability of information important to the qualifications of directors and required by Rule 20a of the 1940 Act is not at issue in the instant case.

Matters of importance to shareholders in voting upon investment advisory agreements (disclosures of which are not at issue here) include the financial position of the adviser and information concerning the executive officers of the adviser. Proxy statements traditionally discuss the various types of compensation received by an adviser from the mutual fund, but do not disclose alternatives possibly available to mutual funds, which are not availed of because of the good faith business judgment of the directors. The shareholders of the Fund were not required to vote, and, to the best of our knowledge, shareholders of mutual funds typically do not vote, on the discreet question of whether to recapture.[15]

We submit that the possibility of recapture is no more important to a shareholder voting on an investment advisory agreement than other alternatives which may have been considered and rejected by the directors, such as the selection of one of a range of possible advisory fees,[16] the

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[14] Thus, the proxy rules promulgated by the SEC under the 1940 Act require information about the principal occupation of all directors and their relationships with the mutual fund. See Regulations 20a-2(a)(5)-(9), (11) and 20a-3(b).

[15] Commission sharing may be among the many provisions in an advisory agreement voted upon by the shareholders.

[16] Advisory fees, which are subject to negotiation between the adviser and the mutual fund, are subject to no minimum or fixed

allocation of expenses between the mutual fund and its adviser, whether the advisory fee should be asset based or performance based, the amount of the sales load on sales of the mutual fund shares, the manner by which the shares of the mutual fund are distributed or discussions relating to specific investment techniques utilized by the adviser—none of which matters are or should be normally disclosed in the context of a vote on an investment advisory agreement.

II.

The Court's decision relating to a no longer relevant practice will have a disruptive impact on the mutual fund industry.

The mutual fund industry has been literally inundated by litigation over the last 15 to 20 years. The first major wave of litigation involved the "reasonableness" of the advisory fee. This was followed by litigation concerning the sale of control of mutual funds and then by a further flood of litigation involving mutual fund brokerage practices. In general, the litigation has subsided for a variety of reasons, including the fact that Congress has essentially dealt with each of the areas that was the subject of litigations. The question of the reasonableness of management fees was explicitly considered by the 1970 Amendments in Section 36(b) of the 1940 Act; the issue of the sale of control of mutual funds was focused upon in the Securities Acts Amendments of 1975 (the "1975 Amendments") by Section 15(f) of the 1940 Act; and the question of brokerage practices was dealt with in the 1975 Amendments by Sections 6(e) and 11(a) of the Securities Exchange Act of 1934.

Due to the establishment of competitive rates of brokerage commissions, mutual funds basically are no longer faced with the decision of whether to recapture. Thus, the

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rate structure. Thus, the range of possible fees is limitless and the alternatives available to the directors in negotiating a fee are far ranging. Not only is the amount of the fee subject to negotiation, but the composition of the fee is also flexible, *e.g.*, which expenses of operations should be allocated to the mutual fund and which should be allocated to the adviser (subject to certain state law restrictions).

recapture issue has for practical purposes become moot and the Court's requirement of the disclosure at issue will not be a guide to future conduct.

As indicated, the Fund was not unique in not disclosing the directors' consideration and rejection of recapture. Thus, the Court's decision could have a wide ranging disruptive impact upon the mutual fund industry, casting doubt about actions taken under proxy statements in prior years. A whole new round of litigation could be triggered, involving many of the same substantive matters that have already been addressed by Congress, but contending that inadequate disclosure has been made respecting these issues. Furthermore, the Court's decision is likely to precipitate additional litigation alleging non-disclosure of any number of other alternatives considered and rejected by directors where such disclosures had not been made by members of the mutual fund or other industries. Mutual fund shareholders will not be benefited by the proposed disclosure due to the mootness of the recapture issue, and unknown and uncertain liabilities on a broad basis could be created by the Court's decision.

CONCLUSION

For the reasons stated, the petition of Robert G. Zeller, F. Eberstadt & Co., Inc. and F. Eberstadt & Co., Managers and Distributors, Inc. for rehearing, or, alternatively, rehearing *en banc* should be granted.

Dated: New York, New York
April 1, 1977

FRIED, FRANK, HARRIS, SHRIVER & JACOBSON
Attorneys for Investment Company Institute

By: Daniel P. Scheckter
a member of the firm

DAVID SILVER, ESQ.
MATTHEW P. FINK, ESQ.
Investment Company Institute
Of Counsel

C 321—Affidavit of Service by Mail.
Affirmation of Service by Mail on Reverse Side.

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U. S. Court of Appeals - 2nd Circuit

Index No. 75-7503

Susan Tannenbaum

Plaintiff
Appellant

against

Robert G. Zeller, et al,

Defendant(s)
appellees

AFFIDAVIT OF SERVICE BY MAIL

STATE OF NEW YORK, COUNTY OF New York ss.:

The undersigned being duly sworn, deposes and says:

Deponent is not a party to the action, is over 18 years of age and resides at 84-10 Main St, Kew Gardens, N.Y.

That on the 1st day of April 1977 deponent served the annexed Notice of Motion and Brief of Investment Company Institute, amicus curiae on Securities and Exchange Commission, Washington, D.C.
attorney(s) for Amicus Curiae
in this action at Washington, D.C. 20549
the address designated by said attorney(s) for that purpose by depositing a true copy of same enclosed in a postpaid properly addressed wrapper, in — ~~a post office~~ — official depository under the exclusive care and custody of the United States post office department within the State of New York.

Sworn to before me
this 1st day of April 1977

Sidney Bogen
The name signed must be printed beneath

Robert E Gerber

ROBERT E. GERBER
Notary Public, State of New York
No. 31-1460150
Qualified in New York County
Commission Expires March 30, 1979

C 321—Affirmation of Service by Mail.
Affidavit of Service by Mail on Reverse Side.

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Plaintiff against Defendant	Index No. ATTORNEY'S AFFIRMATION OF SERVICE BY MAIL

STATE OF NEW YORK, COUNTY OF ss.:

The undersigned, attorney at law of the State of New York affirms: that deponent is attorney(s) of record for

That on the day of 19 deponent served the annexed

on
attorney(s) for
in this action at
the address designated by said attorney(s) for that purpose by depositing a true copy of same enclosed in a postpaid properly addressed wrapper, in — a post office — official depository under the exclusive care and custody of the United States post office department within the State of New York.

The undersigned affirms the foregoing statement to be true under the penalties of perjury.

Dated this day of 19

.....
The name signed must be printed beneath

Attorney at Law

COPY RECEIVED

WALSH & FRISCH

ATTORNEYS FOR